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SUBJECT: U.S. SUBPRIME MARKET FALLOUT REVERBERATES IN GERMANY

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¶1. (SBU) SUMMARY. Fall out from the U.S. subprime mortgage market continues to reverberate in Germany. IKB, a Dusseldorf based bank, has chalked up losses of approximately 3 billion euros ($4.1 billion), staving off insolvency due to a bailout of 3.5 billion euros ($4.79 billion) led by state-owned KFW. Contacts at IKB believe that banking losses will lead to more regulation by the German government. The ECB responded to the crisis by pumping more than two hundred billion euros into European financial markets, but remains sanguine that market disruptions are temporary. Contacts within the German government agree the fundamentals of the U.S. and global financial system remain strong. They support the USG's call for calm and the need to ensure liquidity in global markets. Contacts at the Chancellery, while supportive of U.S. policy in general, question whether such crises could be avoided in the future with stronger regulation of hedge funds. The Finance Ministry believes policymakers should work to stabilize markets and determine the root causes only after the crisis has passed. In contrast, Economic Ministry officials are concerned about the impact of a major market downturn on the German economy as a whole. END SUMMARY

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¶2. (SBU) The German bank most affected by the fallout of the U.S. subprime market is Duesseldorf-based IKB Deutsche Industriebank AG. The bank invested a total of 7.8 billion euros ($10.68 billion) in risky subprime mortgages. Its estimated total losses are approximately 3 billion euros ($4.1 billion). Traditionally, a steep loss like this would have meant bankruptcy for the bank, and might have sparked a deeper financial crisis. To avoid this, KFW, a state-owned lender, and other German banks offered a 3.5 billion euro ($4.79 billion) bail out, with guarantees totalling 8.3 billion euros ($11.37 billion).

¶3. (SBU) German Federal Financial Supervisory Authority (BaFin) auditors are reviewing IKB books and are expected to issue a detailed report on the extent of losses by the end of August. IKB expects a broad political debate in the Bundestag and at the state level about KFW's intervention and whether new regulations are necessary to avoid future crises.

¶4. (SBU) On August 15, CG Dusseldorf spoke with Clemens Jahn, the head of IKB Private Equity, a subsidiary of IKB. According to Jahn, other affected banks in North-Rhine Westphalia are WestLB, Postbank, and Sal Oppenheim. All banks in Germany are being hit in one way or another, at least in terms of the general level of trust in the financial system - and thus their willingness to lend to each other. It is too early to tell if there are more serious problems waiting to be discovered. Jahn believes the bank will survive the crisis. However, if losses at IKB are higher than 3 billion euros, pressure will build for a political debate over the appropriateness of spending more KFW money to cover further losses.

¶5. (SBU) IKB expects the crisis will result in more regulation for the German financial industry. The bank believes BaFin will take measures to enhance transparency, such as requiring off-balance-sheet activities to be listed on financial institutions' balance sheets. These regulations will be on top of those already in place and, IKB argues, will impose a further burden on smaller banks such as itself. IKB does not believe more regulation is the answer, however, as regulators usually respond to the last crisis and are notoriously bad at anticipating new movements in the financial sector.

THE ECB STEPS IN
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¶6. (SBU) The Frankfurt-based European Central Bank (ECB) has taken strong action to limit the extent of the fallout on European markets by injecting over two hundred billion euros into financial markets to ensure liquidity. On August 15, CG Frankfurt met with

Francesco Papadia, Director General for Market Operations at the European Central Bank, to discuss the subprime crisis. Papadia described the current situation as "close to normal," and said that the situation was probably a needed correction to the recent "Panglossian days." The ECB would prefer not to keep injecting liquidity in the market, but would do whatever is necessary to stabilize the market. He added that technically there is no limit to ECB infusions.

¶7. (SBU) Papadia said that banks probably overreacted to the liquidity crisis. He felt a certain amount of the demand was based on panic, as evinced by the precipitous decline in liquidity at the beginning of the crisis. He described this situation as a market inefficiency that the ECB had to help alleviate. Papadia believes that any structural problems that contributed to the crisis were in the U.S. fund rating system and mortgage market and therefore not European in origin.

THE VIEW FROM THE CHANCELLERY
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¶8. (SBU) On August 17, EconOff met with Ludger Schlief, Head of the Chancellery's Finance Policy Division, to discuss the crisis. The Chancellery believes that global actions taken to stabilize markets and reassure investors of the overall soundness of the U.S. economy are working. They support the ECB's move to inject much needed liquidity into financial markets. The German government however, is concerned that problems in the subprime market could lead to a crisis in confidence in the U.S. economy that could spread to Europe. For that reason, Schlief said that it is important for major economies to work together to coordinate responses to send a clear message to the markets.

¶9. (SBU) The Chancellery also raised the issue of the underlying causes of the crisis. Returning to a theme often raised by the Chancellor during Germany's G-8 presidency, Schlief speculated that requiring more regulation of hedge funds could be one way to ensure transparency and avoid further such crises.

THE FINANCE MINISTRY
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¶10. (SBU) Dr. Thorsten Poetzsch, Deputy Director General for Banking and Finance Issues at the Ministry of Finance, expressed confidence that international markets will survive the current volatility with no long term impact. Poetzsch said it is important to ensure the problems in the subprime market do not spread to other sectors. He added, however, that it is too early to speculate on the impact of the crisis on German policy and financial regulations. At this stage the most important task for governments is to contain the crisis and restore confidence in global financial markets.

THE ECONOMIC MINISTRY
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¶11. (SBU) Dr. Albert Caspers, Head of the Macroeconomic Division of the Ministry of Economics, echoed the opinion of the Chancellery and Finance Ministry. He is satisfied that everything is being done to stabilize markets and ensure confidence. The Economic Ministry believes the U.S. and German economies are fundamentally strong and can weather this crisis. Caspers noted that the German economy is in the midst of a robust upswing and believes the crisis should have no immediate impact. However, he did express concern over the danger to the German economy of a global slowdown.

¶11. This cable was coordinated with consul generals Dusseldorf and Frankfurt.

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